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Volume 5 | Number 13 Article 1

7-8-1994

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Agricultural Law Digest

An Agricultural Law Press Publication | Volume 5, No. 13 | July 8, 1994
Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

INSTALLMENT SALE OF PARTNERSHIP INTERESTS

— by Neil E. Harl*

Estate and business planning efforts often involve the sale of interests in the farm or ranch business, usually from parents to children or others succeeding to ownership and management in the operation.[1] A major concern in many instances is whether the sale is eligible for installment reporting of gain.[2] For sales of partnership interests, installment reporting is subject to additional rules not encountered in sales of corporate interests.[3]

General rule

In general, the sale of an entire business organized as a sole proprietorship is treated as a sale of individual assets of the business.[4] Thus, the installment sale of a sole proprietorship is considered to be a sale of the individual assets of the business for purposes of installment reporting of gain.[5] It is important to keep in mind that installment reporting is not available for the sale of depreciable property between closely related persons.[6] Therefore, installment sales of depreciable property between related parties are ineffective to defer recognition of gain beyond the year of sale.[7]

By contrast, the sale of a partnership interest is generally treated as the sale of a single capital asset without regard to the nature of the underlying partnership property.[8] Gain recognized on the sale of a partnership interest is reportable under the installment method of reporting.[9]

Special partnership limit

Sales of partnership interests are subject to an additional and highly important provision.[10] Under I.R.C. § 751, the sale of a partnership interest attributable to inventory or unrealized receivables is treated as the sale of property other than a capital asset.[11]

Section 751 was enacted to prevent the conversion of potential ordinary income into capital gain upon the sale or exchange of a partnership interest.[12] Thus, to the extent sale of a partnership interest represents substantially appreciated inventory or unrealized receivables, the income tax consequences to the transferor partner are "the same tax consequences which would be accorded an individual entrepreneur."[13] The transferor partner is treated as disposing of the unrealized receivables and substantially appreciated inventory "independently of the rest of his partnership interest."[14]

Although gain on the sale of a partnership interest is reportable under the installment method of reporting under the general rule,[15] Section 751 effectively treats a partner as if the partner had sold an interest in any unrealized receivables and substantially appreciated inventory. Therefore, the portion of the gain that is attributable to unrealized receivables and substantially appreciated inventory is reportable under the installment method only to the extent that income realized on a direct sale would be reportable as an installment transaction.[16] Inasmuch as the installment method of reporting gain is ordinarily not available on a direct sale of inventory by a sale proprietor, the IRS position is that the installment method is not available for reporting income from the sale of a partnership interest to the extent attributable to unrealized receivables or substantially appreciated inventory.[17]

The IRS position is premised on the fact that I.R.C. § 452(b)(2)(B) precludes installment reporting in the case of a sale of personal property "that is required to be included in inventory of the taxpayer if on hand at the close of the taxable year."[18] That subsection of the Internal Revenue Code was added in 1980 in response to complaints by farmers that a late 1979 private letter ruling[19] had jeopardized the deferred method of reporting the sale of farm commodities.[20] The effect of the 1980 amendment to I.R.C. § 453, the installment reporting provision, was to allow farmers and ranchers on the cash method of accounting to sell what would otherwise be inventory property on the installment method of reporting. The brief subsection specifies that the term "installment sale" does not include —

> "A disposition of personal property of a kind which is required to be included in inventory of the taxpayer if on hand at the close of the taxable year."

Therefore, it would appear that a farmer or rancher on the cash method of accounting could utilize the installment method of reporting for sales of partnership interests even if the interest includes substantially appreciated inventory. This situation, however, has not yet been ruled upon by IRS.

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FOOTNOTES

1 See generally 6 Harl, *Agricultural Law*, chs. 47, 48 (1994); Harl, *Agricultural Law Manual* §§ 6.02, 6.03 (1994).

2 I.R.C. § 453.

Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 5444, Madison, WI 53705, bimonthly except June and December. Annual subscription $100. Printed on recycled paper by Accurate Business Service, Madison, WI.

[3] Rev. Rul. 84-108, 1989-2 C.B. 100.
[4] See, e.g., Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).
[5] Rev. Rul. 68-13, 1968-1 C.B. 195.
[6] I.R.C. § 403(g). See Harl, "Related Party Sales," 5 *Agric. L. Dig.* 65 (1994).
[7] I.R.C. § 453(g).
[8] See I.R.C. § 741. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954).
[9] Rev. Rul. 76-483, 1976-2 C.B. 131.
[10] I.R.C. § 751.
[11] I.R.C. §§ 1221, 1222.
[12] Rev. Rul. 89-108, 1989-2 C.B. 100.
[13] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 71.
[14] S. Rep. No. 1622, 83d Cong., 2d Sess. 98, 99 (1954).
[15] See Rev. Rul. 76-483, 1976-2 C.B. 131.
[16] Rev. Rul. 89-108, 1989-2 C.B. 100.
[17] *Id.*
[18] *Id.*
[19] Ltr. Rul. 8001001, Sept. 4, 1979.
[20] See Rev. Rul. 58-162, 1958-1 C.B. 234. See also Harl, "Deferred Payment Sales: AMT Liability," 4 *Agric. L. Dig.* 17 (1993).

Note: Copies of past articles in *Agric. L. Dig.* can be ordered for $3,00 each from Agricultural Law Press, P.O. Box 5444, Madison, WI 53705.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. A creditor loaned money to the debtor who granted a security interest in farm machinery and growing crops to secure the loan. The creditor sought to deny the debtor a discharge under either Section 727 or 523 because the debtor failed to apply the proceeds of the sale of the crop to the loan, the debtor did not own a piece of equipment pledged as security for the loan, and the debtor no longer had possession of other equipment pledged as collateral. The court held that discharge would not be denied to the debtor because the creditor failed to demonstrate that the debtor willfully and maliciously intended to harm the creditor financially by not applying the proceeds of the crop sale to the loan. The court also held that the debtor truly believed, although erroneously, that the debtor owned the piece of farm equipment and had no idea where the other equipment was located. ***In re* Lane, 166 B.R. 133 (Bankr. E.D. Mo. 1993)**.

EXEMPTIONS

HOMESTEAD. The debtors claimed a homestead exemption for their farm homestead which had consensual liens against it in excess of the fair market value. The court held that the debtors could not avoid judgment liens against the property because the debtors had no equity in the property. ***In re* Ivie, 165 B.R. 477 (Bankr. D. Mont. 1994)**.

The debtor was a factory worker and claimed a 25 acre parcel of rural property as exempt under Wis. Stat. § 990.01(14). The parcel contained a one acre residential area, about 10 acres of timberland used for wood used for heating , about five acres of pasture used for livestock, and about ten acres of tillable land used to grow feed for the livestock. The value of all of the land was $41,800. The court held that the debtor could exempt as much of the land as was valued at $40,000, the monetary limit of the homestead exemption, because the objecting creditor had not shown that the land was not reasonably necessary for the debtor's use as a home. ***In re* Burgus, 166 B.R. 126 (W.D. Wis. 1991), *aff'g*, 166 B.R. 121 (Bankr. W.D. Wis. 1990)**.

INHERITED PROPERTY. The debtors received inherited property within 180 days after the filing of the petition and claimed the property as exempt under Md. Code Cts. & Jud. Proc. § 11-504(b)(2) which exempted "money payable in the event of … death of any person." The debtors argued that an inheritance was money payable because of the death of the decedent. The court held that although the statute was ambiguous, the intent of the legislature was not to include inherited property in the exemption. ***In re* Royal, 165 B.R. 802 (Bankr. D. Md. 1994)**.

SAVINGS BONDS. The debtors purchased Series EE savings bonds using tenancy by the entireties property and claimed the bonds as exempt tenancy by the entireties property. The court held that the ownership of the bonds was governed by federal regulations which allowed each owner to redeem the bonds; therefore, the debtors could not exempt the bonds as entireties property. ***In re* Pernia, 165 B.R. 581 (Bankr. D. Md. 1994)**.

SETOFF. The debtor had obtained a loan from the FmHA on which the debtor had defaulted pre-petition. The debtor had also enrolled farm land in the Conservation Reserve Program (CRP). The FmHA notified the debtor of its application to the ASCS to offset the debtor's CRP payments against the default on the debtor's FmHA loan. The offset was allowed and the debtor filed for Chapter 13 and the debtor assumed the CRP contract. The debtor argued that the FmHA was not entitled to offset the CRP payments in the bankruptcy case because the CRP contract was executory and contingent upon the debtor's performance. In addition, the assumption of the contract post-petition destroyed the mutuality between the pre- and post-petition CRP contracts. The court held that the filing of the bankruptcy case and assumption of the CRP contract did not change the basic rights and obligations of the parties and that the CRP payments could be offset against the debtor's debt to the FmHA. ***In re* Buckner, 165 B.R. 942 (D.Kan. 1994)**.

CHAPTER 12-*ALM* § 13.03[8].*

DISMISSAL. The debtors filed a voluntary dismissal of their Chapter 12 case. The court found that the debtors failed to properly prosecute their case and abused the bankruptcy process by failing to file complete valuation and financial schedules. The court granted the dismissal but held that the debtors could not refile a bankruptcy case for at least 180 days. ***In re* Hildreth, 165 B.R. 429 (Bankr. N.D. Ohio 1994)**.